

Message Text

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PAGE 01 LONDON 12122 01 OF 08 221721Z
ACTION EUR-12

INFO OCT-01 EA-07 NEA-10 IO-13 ISO-00 AGRE-00 CEA-01
CIAE-00 DODE-00 EB-07 FRB-03 H-01 INR-07 INT-05
L-03 LAB-04 NSAE-00 NSC-05 PA-01 EPG-02 AID-05
SS-15 STR-04 ITC-01 USIA-06 PRS-01 SP-02 FEAE-00
OMB-01 /117 W
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R 221616Z JUL 77
FM AMEMBASSY LONDON
TO SECSTATE WASHDC 6382
TREASURY DEPT WASHDC
INFO AMEMBASSY BONN
AMEMBASSY BRUSSELS
AMEMBASSY DUBLIN
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PAGE 02 LONDON 12122 01 OF 08 221721Z

SUBJECT: SHORT-TERM OUTLOOK FOR THE UK ECONOMY

1. SUMMARY: THE UK HAS MADE CONSIDERABLE PROGRESS FINANCIALLY SINCE AUGUST-OCTOBER 1976, WHEN THE MONETARY AGGREGATES GAVE THE IMPRESSION OF BEING OUT OF CONTROL AND AN ILL-FOUNDED PRESS RUMOUR COULD SEND THE POUND TO \$1.56, CREATING HAVOC IN THE FOREIGN EXCHANGE MARKETS.

SINCE THEN THE GOVERNMENT HAS SHOWN AN ABILITY TO PURSUE FISCAL AND MONETARY POLICY WHICH HAVE STABILIZED A PREVIOUSLY CHAOTIC SITUATION. THE GROWTH IN THE MONEY SUPPLY WAS CHECKED BY MASSIVE SALES OF GILTS WHILE THE RIGOROUS IMPOSITION OF CASH LIMITS CHECKED THE GROWTH IN PUBLIC EXPENDITURE.

2. THIS ESSENTIAL ELEMENT OF CONTROL IS LINKED TO LAST DECEMBER'S IMF LETTER OF INTENT AND THE BASLE AGREEMENT UNDERPINNING OFFICIAL STERLING HOLDINGS. COUPLED WITH A ONE-TIME CHANGE IN FOREIGN EXCHANGE CONTROLS, THESE AGREEMENTS HAD THE EFFECT OF RENEWING INTERNATIONAL CONFIDENCE IN STERLING AND IN THE ABILITY OF THE UK AUTHORITIES TO CONTROL THEIR DOMESTIC SITUATION. THE RESULT HAS BEEN A REVERSAL OF LEADS AND LAGS. HEAVY FOREIGN EXCHANGE INFLOWS. A SUCCESSFUL RENEWAL OF UK INTERNATIONAL BORROWING. AND HEAVY GAINS IN OFFICIAL RESERVES. FROM \$4.1 BILLION IN DECEMBER 1976 TO \$11.6 BILLION IN JUNE 1977.

3. NOT SURPRISINGLY, THE PERFORMANCE OF REAL ECONOMIC AGGREGATES HAS LAGGED BEHIND THAT OF THE FINANCIAL INDICATORS. GROWTH BOTH IN GDP AND MANUFACTURING INVESTMENT THIS YEAR WILL BE LESS THAN ANTICIPATED IN THE MARCH 1977 BUDGET. UNEMPLOYMENT HAS GROWN AND WILL REMAIN HIGH. THE SOMEWHAT SOONER THAN EXPECTED IMPROVEMENT IN CURRENT ACCOUNT IS DUE MORE TO NORTH SEA OIL THAN TO AN INCREASE LIMITED OFFICIAL USE

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PAGE 03 LONDON 12122 01 OF 08 221721Z

IN NON-OIL EXPORTS. ON THE POSITIVE SIDE. PROFITS ARE HIGHER (ALTHOUGH FROM A LOW BASE). THE POUND IS STABLE. INTEREST RATES HAVE BEEN REDUCED SHARPLY, THERE APPEARS TO BE A GOOD HARVEST, PHASE 2 AVERAGE EARNINGS WILL BE IN THE 10 PERCENT RANGE, ALL OF WHICH AUGERS WELL FOR PROGRESSIVE REDUCTIONS, PERHAPS FAIRLY SHARPLY, IN THE RATE OF INFLATION FOR THE REST OF THIS YEAR AND THE FIRST HALF OF 1978.

4. A KEY ELEMENT OF UNCERTAINTY IN ANY FORECAST OF GROWTH AND INFLATION IS WHAT WILL HAPPEN TO AVERAGE EARNINGS IN THE PERIOD FROM AUGUST 1, 1977 TO AUGUST 1, 1978. FORECASTS BY THE NATIONAL INSTITUTE (LONDON 9274) AND BUSINESS ECONOMISTS (LONDON A-430) STRESS THIS POINT. IF WAGE INCREASES CAN BE HELD LOW ENOUGH TO PRODUCE A RISE IN AVERAGE EARNINGS IN THE YEAR TO JULY 1978 OF 10-11 PERCENT. THEN INFLATION MAY FALL FROM ITS CURRENT 17 PERCENT LEVEL TO 8-9 PERCENT BY MID-1978 AND STABILIZE. SHOULD AVERAGE EARNINGS REBOUND TO A 15-16 PERCENT RANGE, IT IS UNLIKELY THAT AVERAGE INFLATION WOULD FALL BELOW 11-12 PERCENT IN 1978, ALTHOUGH IT COULD BRIEFLY BREAK THE 10 PERCENT LEVEL BEFORE REBOUNDED UPWARD

5. WHATEVER HAPPENS TO AVERAGE EARNINGS, THE OUTLOOK FOR THE REMAINDER OF THIS YEAR AND 1978 IS ONE OF SLOWLY ACCELERATING REAL GROWTH FROM ABOUT 0.5 TO 1.0 PERCENT IN 1977, UP TO 2.5-3.0 PERCENT IN 1978. THE BALANCE OF PAYMENTS ON CURRENT ACCOUNT MAY ACTUALLY SHOW A SMALL SURPLUS THIS YEAR. AND A \$2 TO \$3 BILLION SURPLUS IN

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PAGE 01 LONDON 12122 02 OF 08 221738Z
ACTION EUR-12

INFO OCT-01 EA-07 NEA-10 IO-13 ISO-00 AGRE-00 CEA-01
CIAE-00 DODE-00 EB-07 FRB-03 H-01 INR-07 INT-05
L-03 LAB-04 NSAE-00 NSC-05 PA-01 EPG-02 AID-05
SS-15 STR-04 ITC-01 USIA-06 PRS-01 SP-02 FEAE-00
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LIMITED OFFICIAL USE SECTION 02 OF 08 LONDON 12122

1978. ANY MEANINGFUL REDUCTION IN UNEMPLOYMENT WILL ONLY COME SLOWLY. HOWEVER, DESPITE A SIGNIFICANT INCREASE IN MANUFACTURING INVESTMENT THIS YEAR AND NEXT (ALTHOUGH NOT AS HIGH AS ORIGINALLY FORECAST BY THE GOVERNMENT).

6. WHAT IS UNKNOWN IS THE GOVERNMENT'S RESPONSE IN A POLITICALLY CHARGED ATMOSPHERE TO THE CONTINUING HIGH UNEMPLOYMENT AND GROWING CURRENT ACCOUNT SURPLUS THE IMF LIMITED OFFICIAL USE

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PAGE 02 LONDON 12122 02 OF 08 221738Z

LETTER OF INTENT PLACES CONSTRAINTS ON THE GOVERNMENT'S ACTIONS. IT REMAINS TO BE SEEN WHETHER THE GOVERNMENT WILL PERSEVERE IN HOLDING DOWN DOMESTIC CONSUMPTION IN ORDER TO FREE RESOURCES FOR EXPORTS AND INVESTMENT, OR WHETHER POLITICAL PRESSURES WILL BE SUCH TO LEAD IT TO REJECT THE IMF CONSTRAINTS ON PUBLIC SECTOR BORROWING AND DOMESTIC CREDIT EXPANSION AND OPT FOR A CONSUMER-LED EXPANSION. THIS COULD RAISE IMPORTS, DIVERT EXPORTS AND FURTHER REKINDLE WAGE-GENERATED INFLATION. THESE NOXIOUS EFFECTS WOULD TO SOME EXTENT BE MASKED BY NORTH SEA OIL REVENUES. I.E., THE HANGOVER WOULD BE POSTPONED.

7. IT IS LIKELY THAT THE GOVERNMENT WILL TRY TO ADOPT A MIDDLE COURSE OF MILD REFLATION IN NEXT SPRING'S BUDGET. THIS, LINKED WITH EXPECTED HIGHER WAGE LEVELS AND AN UP/TURN IN PERSONAL DISPOSABLE INCOME, WILL HOPEFULLY BE SUFFICIENT TO STAVE OFF CRIES FOR A MORE GENERALIZED REFLATION. THESE HAVE ALREADY BEEN HEARD FROM THE LEFT WING OF THE LABOR PARTY. REPLYING TO A QUESTION IN PARLIAMENT WHY THE UK DID NOT TAKE ACTION UNILATERALLY TO CANCEL THE IMF LOAN AND START A PROGRAM OF REFLATION WITHOUT DELAY, THE PRIME MINISTER URGED HIS QUESTIONER TO CONSIDER THE EFFECT OF CANCELLATION ON INTERNATIONAL CONFIDENCE IN BRITAIN. THE PRIME MINISTER'S RESOLVE IS BOUND TO BE TESTED SEVERELY DURING THE NEXT TWELVE MONTHS.

8. THE REMAINDER OF THIS MESSAGE ATTEMPTS TO LOOK AT THE LIKELY PERFORMANCE OF THE ECONOMY OVER THE PERIOD AND TO COMMENT ON SOME OF THE POINTS RAISED ABOVE. THE FINAL SECTION IS A TECHNICAL APPENDIX WHICH THE GENERAL READER NEED NOT READ. IT CONTAINS THE PERSONAL VIEWS OF HM LIMITED OFFICIAL USE

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PAGE 03 LONDON 12122 02 OF 08 221738Z

TREASURY FORECASTERS ON CHANGES IN THE ECONOMIC SITUATION AND FORECASTING TECHNIQUES SINCE THE PREPARATION OF THE MARCH BUDGET. THESE HELPED PROVIDE BACKGROUND FOR OUR OWN ASSUMPTIONS AND ASSESSMENT, AND ARE OFFERED AS SUCH. END SUMMARY.

9. DURING THE PAST YEAR, UK ECONOMIC PERFORMANCE HAS IMPROVED, ALTHOUGH THE LEVEL OF ACTIVITY IS RESTRAINED AND UNEMPLOYMENT IS HIGH AND STILL RISING. FROM THIS POSITION, THE OBVIOUS NEXT STEP IS GRADUALLY TO MOVE TOWARD HIGHER LEVELS OF OUTPUT AND EMPLOYMENT WHILE AVOIDING A RELAPSE INTO ACCELERATING PRICES AND A DETERIORATING EXTERNAL BALANCE. BRITAIN IS NOT ALONE IN FINDING DIFFICULTIES IN TRANSLATING THE OBVIOUS INTO THE ACHIEVABLE. PART OF THE DIFFICULTY LIES IN THE WAY HMG CHOOSES TO OPERATE ON THE ECONOMIC POLICY VARIABLES UNDER ITS DIRECT CONTROL.

10. THE RECENT INCIDENT IN PARLIAMENT WHEN HMG'S TAX PROPOSALS WERE AMENDED IN COMMITTEE BY AN UNUSUAL COALITION OF TORIES AND 2 LEFT-WING LABOR MP'S ILLUSTRATES THE PROBLEMS OF POLICY MANAGEMENT THAT CONTINUE TO BEDEVIL THE GOVERNMENT. NEVERTHELESS, THE OUTLINES OF THE LIKELY PUBLIC POLICY CHOICES WHICH WILL INFLUENCE THE BEHAVIOR OF THE ECONOMY OVER THE 6 QUARTERS THROUGH THE END OF 1978 ARE BECOMING MORE VISIBLE.

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PAGE 01 LONDON 12122 03 OF 08 221744Z
ACTION EUR-12

INFO OCT-01 EA-07 NEA-10 IO-13 ISO-00 AGRE-00 CEA-01
CIAE-00 DODE-00 EB-07 FRB-03 H-01 INR-07 INT-05
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LIMITED OFFICIAL USE SECTION 03 OF 08 LONDON 12122

11. FISCAL POLICY. THE RESTRICTIVE FISCAL POLICY STANCE CONTAINED IN THE CHANCELLOR'S MARCH AND JULY 1977 MESSAGES TO PARLIAMENT IS NOT LIKELY TO BE EASED BEFORE THE NEXT BUDGET, DUE IN THE SPRING OF 1978, WHEN A GENERAL ELECTION MAY LOOM LARGE ON THE HORIZON. THAT BUDGET IS LIKELY TO BE SET AGAINST A BACKGROUND OF A GROWING CURRENT-LIMITED OFFICIAL USE

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PAGE 02 LONDON 12122 03 OF 08 221744Z

RENT ACCOUNT SURPLUS, A FALLING RATE OF INFLATION AND UNEMPLOYMENT IN THE RANGE OF 7 PERCENT (1.5 MILLION). UNDER THESE CIRCUMSTANCES IT WOULD BE SURPRISING IF FISCAL POLICY DID NOT BECOME SOMEWHAT MORE EXPANSIONARY. SINCE HMG HAS ALREADY PUBLISHED ITS EXPENDITURE INTENTIONS FOR FY78/79, (THE VOLUME OF SPENDING IS SLATED TO REMAIN UNCHANGED FROM ITS PRESENT LEVEL) A MILDLY EXPANSIONARY BUDGET WOULD IMPLY TAX REDUCTIONS IN EXCESS OF THE ROUGHLY 1.5 BILLION POUNDS REQUIRED TO OFFSET THE FISCAL DRAG NOW DEVELOPING IN THE WAKE OF CURRENT PRICE RISES. THUS, INCOME TAX REDUCTIONS OF UP TO 3.0 BILLION POUNDS PARTIALLY OFFSET BY INDIRECT TAX INCREASES OF PERHAPS 0.5 BILLION POUNDS MAY WELL BE THE ORDER OF THE DAY NEXT APRIL.

12. MONETARY POLICY. AFTER THE CHANCELLOR'S LATEST PRO-NOUNCEMENT. HMG'S MONETARY STANCE REMAINS KEYED TO THE DCE AND PUBLIC SECTOR BORROWING TARGETS CONTAINED IN ITS LETTER OF INTENT TO THE IMF. THESE TARGETS ARE CONSISTENT WITH A GROWTH RANGE OF 9-13 PERCENT FOR STERLING M3 OVER THE 12 MONTHS THROUGH APRIL 1978. AS THE CURRENT ACCOUNT MOVES INTO SURPLUS AND STERLING IS HELD AT OR NEAR ITS PRESENT LEVEL, HMG WILL HAVE TO FIND A MEANS OF PREVENTING INFLOWS FROM ABROAD FROM PUSHING THE GROWTH RATE OF M3 ABOVE THE TARGET RANGE. SALES OF GILT-EDGED SECURITIES ARE THE PRINCIPAL AVAILABLE METHOD, ALTHOUGH SUCH SALES IN THE FACE OF THE INFLOW OF SHORT-TERM CAPITAL ARE LIKELY TO RESULT IN MAINTAINING THE SLOPE OF THE YIELD CURVE. IF THE LEVEL OF PUBLIC EXPENDITURE REMAINS IN LINE WITH PUBLISHED PLANS, IT MAY BE POSSIBLE TO HOLD THE PUBLIC SECTOR BORROWING REQUIREMENT TO THE 8.6 BILLION POUND FY 78/79 TARGET. THE HIGHER LEVEL OF ECONOMIC

ACTIVITY SHOULD INCREASE TAX REVENUES PARTIALLY OFFSET-
TING THE REVENUE LOSSES RESULTING FROM THE PROSPECTIVE
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PAGE 03 LONDON 12122 03 OF 08 221744Z

TAX CUTS.

13. AVERAGE EARNINGS REMAIN THE PRINCIPAL UNCERTAINTY
OVER THE NEXT 12 MONTHS. OUR VIEWS WERE SET OUT IN A
SEPARATE MESSAGE (SEE LONDON 11591). BRIEFLY STATED,
THE GROWTH IN AVERAGE EARNINGS IS LIKELY TO BE IN THE 12
TO 18 PERCENT RANGE, WITH 15-16 PERCENT BEING A REASONABLE
BEST ESTIMATE.

LOOKING MORE SPECIFICALLY AT THE OUTLOOK FOR OUTPUT,
INCOMES, PRICES AND EMPLOYMENT OVER THE NEXT 6 QUAR-
TERS, 1977 SHOWS INCREASING SIGNS OF BECOMING ANOTHER
YEAR OF RELATIVE STAGNATION. IN 1978 THE POTENTIAL EXISTS
FOR THE FIRST MAJOR UPTURN IN THE BRITISH ECONOMY
SINCE 1971-73.

14. CONSUMPTION. DESPITE A TAX CUT WHICH WILL ADD ABOUT
1.3 BILLION POUNDS TO DISPOSABLE INCOMES DURING THE
SECOND HALF OF 1977, REAL CONSUMPTION IS SET TO DECLINE
FOR THE YEAR AS A WHOLE. THE STEEPNESS OF THE DECLINE
(PROBABLY OVER 1 PERCENT) IS DIRECTLY TRACEABLE TO AN UN-
PRECEDENTED FALL IN REAL DISPOSABLE PERSONAL INCOMES
WHICH HAVE DECLINED BY 6.6 PERCENT SINCE THE FIRST QUAR-
TER OF 1975 AND BY 3.6 PERCENT BETWEEN 1976I AND 1977I.
TOWARD THE END OF 1977, LOWER TAXES AND EASING PRICES
SHOULD PERMIT REAL INCOMES TO STABILIZE. IN 1978, THE
VOLUME OF CONSUMER EXPENDITURE SHOULD REVERSE A 4-YEAR
DECLINING TREND AS REAL DISPOSABLE PERSONAL INCOMES BEGIN
TO RISE. HIGHER EARNINGS AND LOWER PERSONAL INCOME TAXA-
TION COUPLED WITH A DECLINING RATE OF INFLATION, AT LEAST
DURING SEPTEMBER 1977 -- MARCH 1978, SHOULD MORE THAN OFF-
SET THE EFFECT OF SOMEWHAT HIGHER UNEMPLOYMENT ON TOTAL
EARNINGS.

15. THE INVESTMENT CLIMATE IS LIKELY TO IMPROVE IN 1978.
AFTER NEARLY 3 YEARS OF DECLINES IN THE RATE OF CHANGE IN
REAL FIXED CAPITAL FORMATION, IMPROVED PROFITS (BOTH IN
ABSOLUTE TERMS AND AT THE MARGIN) SHOULD SPUR THE LONG-
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PAGE 04 LONDON 12122 03 OF 08 221744Z

AWAITED RISE IN MANUFACTURING INVESTMENT.

INTEREST-

SENSITIVE AREAS SUCH AS HOUSING AND STOCK BUILDING COULD
BE AMONG THE BETTER PERFORMING AREAS. FIXED INVESTMENT

APPEARS SET FOR A RECOVERY THAT SHOULD LAST WELL INTO
1978. PROFITS HAVE BEGUN TO INCREASE THEIR RELATIVE SHAR
OF NATIONAL INCOME. OVER THE LAST 9 QUARTERS THE SHARE

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PAGE 01 LONDON 12122 04 OF 08 221748Z
ACTION EUR-12

INFO OCT-01 EA-07 NEA-10 IO-13 ISO-00 AGRE-00 CEA-01
CIAE-00 DODE-00 EB-07 FRB-03 H-01 INR-07 INT-05
L-03 LAB-04 NSAE-00 NSC-05 PA-01 EPG-02 AID-05
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LIMITED OFFICIAL USE SECTION 04 OF 08 LONDON 12122

OF GDP OF PRETAX PROFITS NET OF INVENTORY APPRECIATION
ROSE FROM 5.8 TO 8.0 PERCENT NEARLY MATCHING THE
DECLINE IN THE SHARE OF INCOME FROM EMPLOYMENT (73.6 TO
70.8 PERCENT). THIS FLOW OF RESOURCES TO THE CORPORATE
SECTOR APPEARS TO BOLSTER BUSINESS SURVEY EVIDENCE POINT-
ING TO A SHARP (UP TO 20 PERCENT) RISE IN MANUFACTURING
INVESTMENT IN 1978. SINCE PREVIOUS SURVEY EVIDENCE HAS
CREATED WILDLY EXAGGERATED EXPECTATIONS OF IMPROVED INVES

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PAGE 02 LONDON 12122 04 OF 08 221748Z

MENT SEVERAL CAVEATS ARE IN ORDER. FIRST, ABOUT A THIRD OF THE RECENT IMPROVEMENT IN PROFITS IS ATTRIBUTABLE TO THE IMPACT OF NORTH SEA OIL. NON-OIL RELATED PROFITS HAVE IMPROVED BUT NOT NEARLY AS MUCH AS THE AGGREGATE FIGURES SUGGEST. NEXT, MANUFACTURING INVESTMENT REPRESENTS ONLY 15 TO 20 PERCENT OF TOTAL FIXED INVESTMENT AND OTHER SECTORS SUCH AS HOUSING, THE DISTRIBUTIVE TRADES. "TRANSPORT AND COMMUNICATIONS," AND PUBLIC SERVICES MUST ALSO CONTRIBUTE. WHERE THE GOVERNMENT IS DIRECTLY INVOLVED, THE OUTLOOK IS FOR A FURTHER REDUCTION IN FIXED INVESTMENT ALTHOUGH AT A SLOWER RATE THAN WILL BE THE CASE IN 1977.

16. RETAIL PRICES. AFTER HAVING RISEN AT AN ANNUAL RATE OF 19.6 PERCENT BETWEEN THE SECOND HALF OF 1976 AND THE FIRST HALF OF 1977, RETAIL PRICES SHOULD SLOW MARKEDLY DURING THE SECOND HALF OF THE YEAR. NEVERTHELESS, THE ANNUAL RATE OF INCREASE WILL HAVE TO FALL TO UNDER 10 PERCENT DURING THE SECOND HALF OF THE YEAR FOR THE RATE OF PRICE INCREASE FOR 1977 AS A WHOLE TO IMPROVE ON THE 16.5 PERCENT RATE OF 1976. ON OPTIMISTIC ASSUMPTIONS, SUCH A DECLINE APPEARS POSSIBLE. WHOLESAL PRICE RISES HAVE MODERATED IN RECENT MONTHS AND CUTS IN MORTGAGE RATES,⁸ GASOLINE EXCISE TAXES AND SEASONAL FOOD PRICES WILL ALL BE POSITIVE FACTORS OVER THE NEXT FEW MONTHS. AS A RESULT, THERE IS A GOOD POSSIBILITY THAT THE ANNUAL RATE OF RETAIL PRICE INCREASE WILL FALL SUBSTANTIALLY FROM ITS CURRENT 17.7 PERCENT LEVEL TO PERHAPS 14 PERCENT BY YEAR-END, 11-12 PERCENT BY MARCH 1978, AND POSSIBLY A SHORT-LIVED PERIOD OF UNDER 10 PERCENT DURING THE SECOND QUARTER. WITH AVERAGE EARNINGS INCREASING DURING THE FIRST HALF OF 1978, HIGHER LABOR COSTS SHOULD RETURN RETAIL PRICE INCREASES TO DOUBLE DIGITS DURING THE SECOND HALF

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PAGE 03 LONDON 12122 04 OF 08 221748Z

OF THE YEAR. THEREFORE, DURING 1978 AS A WHOLE, RETAIL PRICES ARE LIKELY TO RISE BY 12-14 PERCENT.

17. UNEMPLOYMENT. WITH UNEMPLOYMENT CURRENTLY STANDING AT A RECORD 5.7 PERCENT (1.35 MILLION) AND THE REAL RATE OF GROWTH IN 1977 UNLIKELY TO BE MUCH ABOVE 1.0 PERCENT, IT IS LIKELY THAT THE JOBLESS TOTAL WILL CRAWL UPWARD OVER THE REMAINDER OF 1977. CURRENT EMPLOYMENT DATA FOR PRODUCTION INDUSTRIES (ABOUT 40 PERCENT OF THE LABOR

FORCE) INDICATE THAT EMPLOYMENT IN THIS CATEGORY ROSE BY 70,000 OVER THE LATEST 12-MONTH PERIOD (APRIL 76-77) INDICATING A SLIGHT SECTORAL RECOVERY IN THE LEVEL OF DEMAND FOR LABOR. THIS RECOVERY MAY BE THE RESULT OF DECLINING REAL WAGES. WITH THE REAL WAGE INCREASING IN 1978, EMPLOYMENT IS NOT LIKELY TO RISE AS RAPIDLY AS OUT-PUT. PREVAILING DEMOGRAPHIC FACTORS COULD THUS PRODUCE AN INCREASE IN THE RATE OF UNEMPLOYMENT TO ABOUT 7.0 PERCENT BY THE END OF 1978 (UP TO 1.6 MILLION).

18. CURRENT ACCOUNT WILL PROBABLY MOVE INTO SURPLUS THIS YEAR AS NORTH SEA OIL PRODUCTION BEGINS TO CLIMB. THE VISIBLE DEFICIT IN OIL SHOULD DECLINE FROM NEARLY 4.0 BILLION POUNDS IN 1976 TO 2.7 BILLION POUNDS IN 1977 AND 1.7 BILLION POUNDS IN 1978 AS NORTH SEA OIL PRODUCTION RISES FROM 12 MILLION TONS A YEAR TO A 40-45 MILLION-TON RANGE THIS YEAR, AND TO A 60-70 MILLION-TON RANGE IN 1978 THIS IMPROVEMENT MAY BE TRANSITORILY SLOWED AS IMPROVEMENT IN THE UK LEVEL OF ECONOMIC ACTIVITY IN 1978 INCREASES PETROLEUM CONSUMPTION.

19. THE NON-OIL TRADE OF THE UK HAS RISEN SHARPLY IN THE FIRST HALF OF 1977, THE VOLUME OF VISIBLE NON-OIL EXPORTS STANDING 5.9 PERCENT ABOVE THE AVERAGE 1976 LEVEL AND THAT OF VISIBLE NON-OIL IMPORTS 7.9 PERCENT ABOVE THE AVERAGE 1976 LEVEL. IMPORTS AND EXPORTS ARE SUBJECT TO DIFFERENT FORCES AND OUGHT TO DEVELOP IN DISTINCTIVE WAYS LIMITED OFFICIAL USE

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PAGE 04 LONDON 12122 04 OF 08 221748Z

OVER THE NEXT YEAR AND A HALF, HOWEVER.

20. THE VOLUME OF VISIBLE NON-OIL IMPORTS ROSE SHARPLY

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PAGE 01 LONDON 12122 05 OF 08 221751Z
ACTION EUR-12

INFO OCT-01 EA-07 NEA-10 IO-13 ISO-00 AGRE-00 CEA-01
CIAE-00 DODE-00 EB-07 FRB-03 H-01 INR-07 INT-05

L-03 LAB-04 NSAE-00 NSC-05 PA-01 EPG-02 AID-05
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R 221616Z JUL 77
FM AMEMBASSY LONDON
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LIMITED OFFICIAL USE SECTION 05 OF 08 LONDON 12122

IN THE FIRST QUARTER OF 1977. BUT SINCE THAT TIME IT HAS
NOT SHOWN STRONG CONSISTENT UPWARD MOVEMENT. THERE IS
SOME INDICATION THAT LAST YEAR'S DECLINING EXCHANGE RATE
MAY HAVE ENGENDERED ANTICIPATORY IMPORT PURCHASES WHICH
WERE DELIVERED IN THE FIRST MONTHS OF 1977 THE SLOW
GROWTH OF OUTPUT SHOULD HOWEVER CHECK IMPORT DEMAND FOR
THE REST OF THIS YEAR. AND LOWER. PERHAPS EVEN NEGATIVE,
ADDITIONS TO STOCKS OF IMPORTED GOODS MAY BE EXPECTED.
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PAGE 02 LONDON 12122 05 OF 08 221751Z

AS A CONSEQUENCE THE VOLUME OF THESE IMPORTS SHOULD DE
CLINE MILDLY OVER THE SECOND HALF OF 1977 TO SHOW A GAIN
OF AROUND 6-1/2 - 7-1/2 PERCENT OVER 1976 LEVELS. IN-
CREASING OUTPUT IN 1978 AND CONTINUING HIGH LEVELS OF IN-
FLATION SHOULD RAISE 1978 NON-OIL IMPORT VOLUME ROUGHLY
4-1/2 - 5.1/2 PERCENT OVER ITS 1977 LEVEL. WE ASSUME
PRICES IN THE UK'S TRADING PARTNERS SHOULD INCREASE 8 PER
CENT IN 1977 AND 7 PERCENT IN 1978. AS A TECHNICAL CON-
VENIENCE THE POUND IS SET AT \$1 72 FOR THE
PURPOSE OF THE CURRENT ACCOUNT FORECAST.

21. THE VOLUME OF VISIBLE NON.OIL EXPORTS HAS BEEN IN-
CREASING ON THE BASIS OF INCREASED COMPETITIVENESS AND OF
THE EXPANSION OF THE ECONOMIES OF THE UK'S TRADING PART-
NERS. AS IT HAS MOVED INTO FULL MEMBERSHIP' THE UK HAS

BECOME INCREASINGLY DEPENDENT ON THE EEC AS A MARKET FOR ITS EXPORTS, THE EEC SHARE IN UK EXPORTS RISING FROM A LITTLE OVER 30 PERCENT IN 1972 TO NEARLY 37 PERCENT CURRENTLY. IF CHANGES IN COMPETITIVENESS ARE FACTORED OUT THE UK'S VISIBLE NON-OIL EXPORTS GROW ABOUT AS RAPIDLY AS INDUSTRIAL PRODUCTION IN THE EEC. THIS MEANS THAT THEY SHOULD GROW A BIT FASTER THAN THE GDP OF THE INDUSTRIAL COUNTRIES, BUT SLOWER THAN THE GROWTH IN AVERAGE INDUSTRIAL COUNTRY FOREIGN TRADE. THE LAGGED RESPONSE OF LAST YEAR'S DEPRECIATION OF STERLING WILL HELP NON-OIL EXPORTS IN 1977 WHOSE VOLUME SHOULD GROW AT AROUND 7-1/2 TO 8-1/2 PERCENT COMPARED TO EEC INDUSTRIAL PRODUCTION AT PERHAPS 4-6 PERCENT. LAGGING GROWTH AND THE RELATIVE STABILITY OF THE POUND SHOULD, HOWEVER, REDUCE NON-OIL EXPORTGROWTH TO 3-1/2-4-1/2 PERCENT IN 1978. FOREIGN PRICES ARE ASSUMED TO GROW AS NOTED FOR IMPORTS.

22. THE BALANCE ON INVISIBLES WILL NOT GROW AS RAPIDLY
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PAGE 03 LONDON 12122 05 OF 08 221751Z

AS IN THE PAST. THE VOLUME OF RECEIPTS FROM TOURIST EXPENDITURES WILL SHOW SUBSTANTIAL GROWTH OF 20 PERCENT IN 1977, RECEIPTS FROM FOREIGN CONSTRUCTION WILL ALSO GROW WHILE MERCHANDISE FREIGHT AND INSURANCE WILL IMPROVE AS PETROLEUM IMPORTS FALL. THE IMPUTED INCOME TO FOREIGN RESIDENTS FROM NORTH SEA OIL HOWEVER WILL RISE SHARPLY, OFFSETTING MOST OF THESE GAINS.

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PAGE 01 LONDON 12122 06 OF 08 221755Z
ACTION EUR-12

INFO OCT-01 EA-07 NEA-10 IO-13 ISO-00 AGRE-00 CEA-01
CIAE-00 DODE-00 EB-07 FRB-03 H-01 INR-07 INT-05
L-03 LAB-04 NSAE-00 NSC-05 PA-01 EPG-02 AID-05
SS-15 STR-04 ITC-01 USIA-06 PRS-01 SP-02 FEAE-00
OMB-01 /117 W

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R 221616Z JUL 77

FM AMEMBASSY LONDON
TO SECSTATE WASHDC 6387
TREASURY DEPT WASHDC
INFO AMEMBASSY BONN
AMEMBASSY BRUSSELS
AMEMBASSY DUBLIN
AMEMBASSY NEW DELHI
AMEMBASSY PARIS
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AMEMBASSY TOKYO
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LIMITED OFFICIAL USE SECTION 06 OF 08 LONDON 12122

23. THE OUTLOOK FOR THE POUND IS ONE OF RELATIVE STABILITY, BARRING ANY MAJOR SHIFTS IN INTERNATIONAL CONFIDENCE. AN IMPROVING CURRENT ACCOUNT WILL PROVIDE SUPPORT. OFF. SETTING THIS WILL BE A CONTINUING INFLATION DIFFERENTIAL AND THE OFFICIAL DECISION TO HOLD INTEREST RATES DOWN TO PROMOTE DOMESTIC INVESTMENT. INTERNATIONAL CONFIDENCE WOULD BE SHAKEN BY A WAGE EXPLOSION OR BY THE GOVERNMENT LIMITED OFFICIAL USE

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PAGE 02 LONDON 12122 06 OF 08 221755Z

ABJURING ITS COMMITMENTS TO THE IMF IN ORDER TO FINANCE A MAJOR DOMESTIC EXPANSION IN THESE CASES' OUTWARD CAPITAL MOVEMENTS AND LEADS AND LAGS COULD DEVELOP WHICH WOULD ADVERSELY AFFECT THE EXCHANGE RATE.

24. IN THE ABSENCE OF SUCH DEVELOPMENTS MOST OBSERVERS SEE THE POUND TRADING SOMEWHERE IN A \$1.65 - \$1.75 RANGE OVER THE NEXT 18 MONTHS. THE NATIONAL INSTITUTE'S CURRENT FORECAST IS NO CHANGE IN THE EFFECTIVE EXCHANGE RATE THROUGH THE END OF 1978. PHILLIPS AND DREW SEES A STEADY DECLINE IN THE DOLLAR/POUND RATE TO A \$1.64 LEVEL BY END 1978. MANY BANKERS EXPECT RELATIVE STABILITY OR A GENTLE DECLINE IN THE RATE FOR THE REST OF THIS YEAR AND INTO NEXT, WITH THE POUND POSSIBLY TRADING AT \$1.64-\$1.68 BY END 1978, TAKING INTO ACCOUNT THE POSSIBILITY OF ACCELERATING INFLATION IN THE SECOND HALF OF NEXT YEAR.

25. OUR CENTRAL ESTIMATE OF THE CURRENT ACCOUNT THIS YEAR AND NEXT WITH ALL FIGURES IN MILLIONS OF POUNDS IS:

1976	1977	1978
------	------	------

(ACTUAL)

PETROLEUM EXPORTS	1162	2085	2870
PETROLEUM IMPORTS	-5126	.4780	-4520
PETROLEUM BALANCE	-3964	-2695	-1650
NON-OIL EXPORTS (FOB)	24132	29835	33200
NON-OIL IMPORTS (FOB)	-23760	-29105	-32680
VISIBLE TRADE BAL	-3592	1965	-1130
INVISIBLES BALANCE	2116	2210	2660
CURRENT ACCOUNT			
BALANCE	-1476	245	1530

THE CONSTITUENT PARTS OF THIS FORECAST MUST BE REGARDED AS SUBJECT TO REASONABLE ERROR. THE CURRENT ACCOUNT IN PARTICULAR SHOULD NOT BE REGARDED AS ANY MORE ACCURATE LIMITED OFFICIAL USE

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PAGE 03 LONDON 12122 06 OF 08 221755Z

THAN A DEVIATION OF PLUS OR MINUS 300 MILLION POUNDS FROM THE CENTRAL FORECAST. SUCH A DEVIATION IS A LITTLE LESS THAN 1 PERCENT OF THE AVERAGE VALUE OF EXPORTS OR IMPORTS OVER THE THREE YEARS.

26. SUBJECT TO ALL OF THE USUAL CAVEATS' WE CURRENTLY EXPECT CHANGES IN THE RATE OF REAL GROWTH OF THE MAJOR ECONOMIC AGGREGATES, EMPLOYMENT AND PRICES TO BE IN THE FOLLOWING RANGE: PERCENT CHANGE FROM PREVIOUS YEAR

	1976	1977	1978
GDP	1.1	0.5-1.0	2.5-3.0
CONSUMPTION	0.2	-1.0 - -1.2	1.7-2.0
FIXED INVESTMENT	-4.4	.2-0	.2-3.0
MANUFACTURING INVESTMENT	-5.0	5.0-7.0	10.0-15.0
INVENTORY CHANGE 1)	1.4	0.4-0.6	1.0-1.2
GOVERNMENT EXPENDITURE	1.4	0	0
VISIBLE TRADE 2)	-3.6	-1.7 - -2.3	.0-1.4
INVISIBLE TRADE 2)	2.1	2.1-2.3	2.6-2.8
CURRENT ACCOUNT 2)	-1.4	-0.1 - 0.5	1.2-1.8
INDUSTRIAL PRODUCTION	0.5	1.5-2.0	3.5-4.5
UNEMPLOYMENT RATE 3)	5.6	6.3	6.8
RETAIL PRICES	16.5	15.5-16.5	12.0-14.0

1) - AS A PERCENT OF GDP

2) - BILLIONS OF POUNDS: 3) . FOR DECEMBER

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PAGE 01 LONDON 12122 07 OF 08 221804Z
ACTION EUR-12

INFO OCT-01 EA-07 NEA-10 IO-13 ISO-00 AGRE-00 CEA-01
CIAE-00 DODE-00 EB-07 FRB-03 H-01 INR-07 INT-05
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OMB-01 /117 W
-----039649 221839Z /41

R 221616Z JUL 77
FM AMEMBASSY LONDON
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AMEMBASSY TOKYO
AMCONSUL BELFAST
AMCONSUL EDINBURGH
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LIMITED OFFICIAL USE SECTION 07 OF 08 LONDON 12122

27. A TECHNICAL APPENDIX: AN INSIDER'S VIEW. IN PRIVATE CONVERSATIONS, HM TREASURY FORECASTERS HAVE SUMMARIZED THEIR OWN VIEWS ON EVOLVING MAJOR ECONOMIC AGGREGATES SINCE THE MARCH 1977 BUDGET (LONDON 5200). THESE ARE OFFERED BY WAY OF BACKGROUND TO OUR OWN ANALYSIS.

828. AVERAGE EARNINGS. HMTREASURY BELIEVES THAT ITS 1976
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PAGE 02 LONDON 12122 07 OF 08 221804Z

FORECAST OF AVERAGE EARNINGS GROWTH HAS BEEN EXTREMELY ACCURATE. IT CURRENTLY ANTICIPATES THAT OVER THE 12 MONTHS THROUGH JULY 1977, PRETAX AVERAGE EARNINGS WILL HAVE RISEN BY ABOUT 9 PERCENT. FOR THE FOLLOWING 12 MONTHS, HMTREASURY'S GOAL IS A 10 PERCENT RISE IN EARNINGS. ADMITTING THIS TO BE OPTIMISTIC, HMT BELIEVES SUCH A LIMIT IS A NECESSARY CONDITION, INTER ALIA, FOR ANY

FURTHER DECLINE IN INTEREST RATES. A RISE OF 15 PERCENT IN EARNINGS THROUGH MID-1978 WOULD CAUSE PRICES TO RISE AT A RATE WHICH WOULD BE INCONSISTENT WITH INTEREST RATES REMAINING AT CURRENT LEVELS. OVER THE COMING MONTHS, SLACK LABOR MARKET CONDITIONS, AN UNEVENLY BASED RECOVERY IN PROFITS, AND GENERALLY WEAK DEMAND ARE EXPECTED TO RULE OUT A REPETITION OF A WAGE EXPLOSION ON THE 1974-75 SCALE.

29. FOR 1977 AS A WHOLE, HMTREASURY HAS REVISED ITS FIRST POST-BUDGET ESTIMATE OF THE DECLINE IN REAL PERSONAL DISPOSABLE INCOME FROM 2.5 TO 3.5 PERCENT. THIS WAS BASED ON A DECLINE OF 7.0 TO 7.5 PERCENT IN PRETAX AVERAGE EARNINGS IN LIGHT OF A YEAR-ON-YEAR RISE OF 15.5 TO 16.5 PERCENT IN RETAIL PRICES.

30. PRICES. HMTREASURY HAS BEEN SURPRISED AT THE TREND IN WHOLESALE PRICE INCREASES WHICH WAS ESTABLISHED IN DECEMBER 1976 AND HAS LASTED THROUGH MAY 1977. UNTIL THE END OF 1976. THE TREASURY MODEL HAD CONSISTENTLY OVERESTIMATED ACTUAL INFLATION AND WAS CORRECTING FOR THIS BIAS BEFORE INITIAL 1977 FORECASTS WERE ESTIMATED. THE ACTUAL RATE OF WHOLESALE PRICE INCREASE IS CLOSER TO WHAT THE UNADJUSTED MODEL WOULD HAVE PREDICTED. SPECULATING ON THE REASONS FOR THIS, HMT SOURCE OPINED THAT UK PRODUCERS OF IMPORT SUBSTITUTES WERE INCREASING PRICES TO CATCH LIMITED OFFICIAL USE

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PAGE 03 LONDON 12122 07 OF 08 221804Z

UP WITH HIGHER IMPORT PRICES. SOURCE DISMISSED THEORY THAT INDUSTRY WAS WIDENING PROFIT MARGINS IN ANTICIPATION OF RELAXATION IN PRICE CONTROLS.

31. INVENTORIES. THE LARGE INVENTORY RUN-UP DURING THE FIRST QUARTER OF 1977 IS DIFFICULT TO EXPLAIN. THE FORECASTING EQUATION BADLY UNDERESTIMATED THE BUILDUP. (THIS IS EXPECTED IN SOME DEGREE AS THE GROWTH IN PRICES. A CENTRAL VARIABLE, DOES NOT HAVE A SIGNIFICANT COEFFICIENT, AND THE FIRST QUARTER WAS CHARACTERIZED BY EXTREMELY LARGE MOVEMENTS IN INTEREST RATES AND PRICES.) THE EQUATION CONTINUED TO UNDER-PREDICT INVENTORY ACCUMULATION, EVEN AFTER A NUMBER OF AD HOC ADJUSTMENTS TO THE COEFFICIENTS WERE CARRIED OUT, WHICH REMOVED ABOUT 40 PERCENT OF THE PREDICTION ERROR. THIS AND THE STARK FALL IN CONSUMPTION EXPENDITURE DURING 1977 I HAS LED THE FORECASTERS TO REGARD A LARGE PART OF THE BUILDUP AS INVOLUNTARY. THIS IMPLIES THAT ADDITIONAL DEFLATIONARY PRESSURE WILL BE GENERATED AS SUPPLIERS TRY TO RUN THOSE UNEXPECTEDLY LARGE STOCK LEVELS DOWN TO DESIRED LEVELS THROUGH THE REST OF THIS YEAR.

OTHER EXPLANATIONS ADVANCED INCLUDED:

- AN ANTICIPATION OF INCREASED LEVELS OF OUTPUT
LATER IN THE YEAR
- A RISE IN IMPORTS INCIDENT UPON FEARS OF POSSIBLE
IMPORT CONTROLS
- THE MARCH LEYLAND STRIKE WHICH CAUSED COMPONENT
MAKERS TO ANTICIPATE HEAVIER PARTS DEMAND UPON
CONCLUSION OF THE STRIKE.

FOR THE REST OF THE YEAR TOTAL STOCKS ARE ANTICIPATED
TO INCREASE BUT SLIGHTLY OVER THE FIRST QUARTER'S LEVEL.

32. EMPLOYMENT. THE OUTLOOK THROUGH 1977 IS FOR FURTHER
MONTHLY RISES WITH THE TOTAL JOBLESS FIGURE IN EXCESS OF
1.4 MILLION BY YEAR-END.

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PAGE 04 LONDON 12122 07 OF 08 221804Z

33. GOVERNMENT SPENDING. HMT SOURCE EXPRESSED FRUSTA-
TION AT INABILITY ACCURATELY TO FORECAST VOLUME OF GOVERN-
MENT SPENDING. FIRST QUARTER 1977 FIGURE WAS ABOUT 2 PER-
CENT LESS THAN ANTICIPATED. SOURCE OPINED THAT THIS WAS
EFFECT OF CASH LIMIT SYSTEM WHICH HAD RESULTED IN DEPART-
MENTS TAKING A MORE CAUTIOUS APPROACH IN THEIR DISBURSE-
MENT POLICIES. HE ANTICIPATED SOME ACCELERATION IN SPEND-

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PAGE 01 LONDON 12122 08 OF 08 221804Z
ACTION EUR-12

INFO OCT-01 EA-07 NEA-10 IO-13 ISO-00 AGRE-00 CEA-01
CIAE-00 DODE-00 EB-07 FRB-03 H-01 INR-07 INT-05
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OMB-01 /117 W

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R 221616Z JUL 77

FM AMEMBASSY LONDON
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LIMITED OFFICIAL USE SECTION 08 OF 08 LONDON 12122

ING LATER IN THE FISCAL YEAR AS DEPARTMENTS FOUND THEMSELVES COMFORTABLY WITHIN SPENDING LIMITS.

34. INVESTMENT. AFTER FORECASTING A RISE OF 17.5 PERCENT IN MANUFACTURING INVESTMENT IN 1977. POOR FIRST QUARTER RESULTS HAD PRODUCED A REVISED ESTIMATE OF 7 TO 9 PERCENT OR THE YEAR. THE DOWNWARD REVISION WAS ATTRIBUTED TO INDUSTRIALISTS DELAYING CAPITAL OUTLAYS UNTIL AFTER DELIMITED OFFICIAL USE

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PAGE 02 LONDON 12122 08 OF 08 221804Z

TAILS ON NEXT WAGE ROUND BECAME KNOWN. SOURCE THEN SAID THAT HMT ANTICIPATED A SHARP UPTURN IN MANUFACTURING INVESTMENT IN 1978 WITH A YEAR-ON-YEAR RISE OF UP TO 20 PERCENT IN REAL TERMS NOT UNLIKELY. AFTER 2 YEARS OF BULLISH INVESTMENT INTENTIONS SURVEYS, HMT HAS BEGUN TO DISCOUNT SUCH EVIDENCE QUITE HEAVILY IN SOME OF THEIR OWN ESTIMATES. THE SHORT-TERM FORECASTS OF INVESTMENT THAT ARE BASED ON INVESTMENT INTENTIONS SURVEYS ARE USUALLY QUITE UNRELIABLE. STUDIES OF THESE SURVEYS SHOW THAT THE ACTUAL INVESTMENT BEHAVIOR OF INDIVIDUAL FIRMS DEVIATES MARKEDLY FROM THE ANSWERS THEY GIVE ON THE SURVEYS -- 100 PERCENT DEVIATIONS BEING COMMON. MEDIUM-TERM FORECASTS BASED ON THE TREASURY'S MODEL, ON THE OTHER HAND, TEND TO BE MORE STABLE.

35. CONSUMPTION. IN ITS REVISED FORECAST FOR 1977. HMT HAS INCREASED THE DECLINE IN REAL CONSUMPTION FROM 0.3 PERCENT TO 1.0 PERCENT. THIS STEMS FROM THE REVISED ESTIMATES ON REAL DISPOSABLE INCOMES.

36. CURRENT ACCOUNT. HMTREASURY BELIEVES THAT THE CURRENT ACCOUNT DEFICIT WILL BE MUCH SMALLER THAN THE 500 MILLION POUNDS ESTIMATED AT THE TIME OF THE CHANCELLOR'S BUDGET. THERE MAY BE A SMALL SURPLUS THIS YEAR, BUT

AS FURTHER CURRENT ACCOUNT IMPROVEMENTS OVER PREVIOUS ESTIMATES WILL PROBABLY DERIVE FROM THE DETERIORATING PERFORMANCE OF THE DOMESTIC ECONOMY. SUCH REVISIONS ARE NOT REGARDED FAVORABLY. MOREOVER, THERE ARE DEVELOPMENTS WHICH CAUSE CONCERN FOR THE MEDIUM-TERM HEALTH OF THE BALANCE OF PAYMENTS.

37. THE BETTER THAN EXPECTED CURRENT ACCOUNT PERFORMANCE IS DUE TO MANY FACTORS. THE MOST PROMINENT OF THESE IS LIMITED OFFICIAL USE

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PAGE 03 LONDON 12122 08 OF 08 221804Z

THE IMPROVED TERMS OF TRADE, RAW MATERIAL PRICES BEING CONSIDERABLY BELOW PREVIOUS EXPECTATIONS. THE INVISIBLES ACCOUNT WILL BE STRONG AS WELL. IN CONSTANT PRICES, TOURIST EXPENDITURE SHOULD BE UP 20 PERCENT, EARNINGS OF THE CITY UP 8 PERCENT, AND RECEIPTS FROM CONSTRUCTION WORK OVERSEAS UP 8 PERCENT.

38. TREASURY FORECASTERS ARE UNEASY ABOUT SEVERAL FACTORS. THE VOLUME OF MANUFACTURING EXPORTS (LESS EXPORTS OF PRECIOUS STONES, SHIPS AND AIRCRAFT), A SERIES CLOSELY WATCHED TO JUDGE UK COMPETITIVE POSITION, HAS NOT INCREASED A GREAT DEAL FROM LAST AUTUMN'S LEVEL. ON THE OTHER SIDE OF THE ACCOUNTS, THE VOLUME OF IMPORTS OF FINISHED MANUFACTURES GREW MUCH MORE RAPIDLY THAN ANTICIPATED IN BOTH 1976 IV AND 1977 I, OSTENSIVELY REFLECTING THE INVENTORY BUILDUP THAT APPEARED IN THE NATIONAL PRODUCT ACCOUNTS FOR 1977 I

39. IT IS NOT CLEAR WHETHER THESE MOVEMENTS WILL CONTINUE INTO THE MEDIUM TERM. INDICES OF UK EXPORT COMPETITIVENESS ARE DIVERGING SHARPLY FROM ONE ANOTHER (THE INDEX OF EXPORT PROFITABILITY RELATIVE TO DOMESTIC SALES PROFITABILITY IS THE ONE INDEX WHICH GIVES CONTINUED GROUNDS FOR OPTIMISM). THE QUANTITATIVE EFFECTS OF ANY OF THE INDICES ARE, HOWEVER, NOT KNOWN. ATTEMPTS TO INTEGRATE THE MEASURES INTO THE TREASURY'S MODEL HAVE NOT TO DATE PRODUCED SATISFACTORY RESULTS.

40. THE REASONS FOR LAST SUMMER'S POOR FORECASTS HAVE NOT BEEN SORTED OUT. RATHER THAN RESPECIFYING AND REESTIMATING THE EQUATION, TREASURY FORECASTERS HAVE SIMPLY CHANGED COEFFICIENTS IN AN AD HOC MANNER. IN PARTICULAR, LAST YEAR'S FALL IN THE UK'S SHARE OF WORLD TRADE HAS BEEN ASSUMED TO BE A ONCE-AND-FOR-ALL SHIFT IN TRADING PATTERNS, AND THIS YEAR'S SHARE IS ASSUMED TO BE UNALTERED. THE GROWTH IN WORLD TRADING VOLUME IN 1977 HAS, LIMITED OFFICIAL USE

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PAGE 04 LONDON 12122 08 OF 08 221804Z

HOWEVER, BEEN REVISED DOWNWARD FROM 10 PERCENT TO SOMETHING ON THE ORDER OF 8 PERCENT.

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Message Attributes

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TAGS: ECON, UK
To: STATE TRSY
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